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Miraka submission to the Commerce Commission:
Process and Issues Paper – Review of 2014/15 Base Milk Price Calculation (7 April 2015)

1.0 In the above paper, the Commission has outlined the areas of focus and the process it will follow in the statutory review of the 2014/15 Base Milk Price Calculation. The review is mandated by the Dairy Industry Restructuring Act (DIRA). Miraka appreciates the opportunity to submit on this paper.

2.0 Legal Framework

2.1 At paragraph 12, the Commission indicates it is "not proposing to substantively change our legal framework (e.g. our interpretation of "efficient processor")". Miraka has previously raised concerns with the way the DIRA has been interpreted when setting the Base Milk Price. Miraka concerns have been largely rejected by the Commission. Miraka view however remains that the Milk Price calculations do not reflect a proper consideration of the NZ dairy environment or the purpose of the DIRA. Failure to address these fundamental issues is a source of frustration, and undermines efforts to improve the basis on which the milk price is able to be determined.

2.2 The legal framework for the milk price calculations has two main purposes:

- To incentivise Fonterra to operate efficiently
- To provide for contestability in the market for the purchase of raw milk

2.3 Miraka contends that rather than achieving these purposes, they are frustrated by the methodology adopted in the Milk Price calculations. A further emerging concern is that the underlying subsidy in the Base Milk Price (compared to the actual performance of Fonterra's commodity ingredients) undermines Fonterra profitability and is disrupting the market for its capital instruments. Because the Fonterra milk price sets the benchmark for the cost of all raw milk purchased in NZ, this subsidy also undermines profitability of the independent dairy companies, and has a dampening effect on further investment.

Incentivising Fonterra to operate efficiently

2.4 The milk price calculations assume that the opportunity to increase profits motivates Fonterra to operate efficiency. This is on the assumption that profit is the primary driver of Fonterra performance. On this basis, the milk price calculations include costs for the Notional Producer which are set independently of Fonterra actual performance,

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including stretch targets that can exceed Fonterra performance (i.e. under the S150A 92) requirement of "practically feasible for an efficient processor"). Miraka has previously submitted that the primary performance driver for Fonterra is in fact the milk price itself, with profit being a secondary driver. This performance focus on the milk price reflects that Fonterra is a co-operative, and is also specifically provided in the Fonterra Constitution. The Base Milk Price calculations however obscure and overstate actual Fonterra milk price performance (the performance of Fonterra's commodity ingredients business). Efficiency improvements do not flow through to this primary performance measure, and the Base Milk Price does not incentivise efficiency improvements. At best, the milk price is neutral to incentivising efficiency, and at worst it disincentivises efficiency as it obscures through overstatement this key performance measure. The Commission does not accept this view, placing greater emphasis on profit as a performance driver.

2.5 The Commission elaborated its position in its final report on the 2013/14 Base Milk Price Calculation (15 September 2014)[1]. The Commission quoted favourably from Fonterra's Milk Price Manual that Fonterra (i.e. not its suppliers) should bear "the financial consequences of costs exceeding an efficient rival's costs" so as to "provide incentives ... to minimise costs and to invest appropriately in processing quantity and quality". While this may be a correct statement of Fonterra's Milk Price Manual, it is contrary to what actually happened in 2013/14. Within the framework established by the base milk price methodology, Fonterra did in fact pass on to suppliers, "the financial consequences of costs exceeding an efficient rivals costs" (e.g. the costs incurred as a result of Fonterra not being able to optimise its product mix in the way the Notional Producer was assumed to be able to do). This moved the milk price towards a more performance based measure. At the same time, it exposed Fonterra performance issues and for example drove Fonterra to make (or at least bring forward) major investment decisions to address those performance issues. This was done NOT to protect Fonterra profits but to protect and maximise the milk price. This outcome is antithetical to the assertion noted above from the Fonterra Milk Price Manual. The Commission however rejects this analysis.

2.6 On the other hand, the Chairman of Fonterra, John Wilson, has made it quite clear in recent statements that maximising the milk price is in fact the key focus for Fonterra. The Commission is encouraged to consider the following recent statements in contrast to the position it has previously taken on this matter:

[1] Refer paragraph 1.30 to 1.36 (and especially paragraph 1.35). Also note that in Paragraph 1.33 the Commission indicates that Miraka has "expressed the concern that Fonterra might have the … incentive to maximise the base milk price". Miraka has never expressed this as a "concern". Miraka rather expressed as simple statement of fact that Fonterra in incentivised (indeed "compelled" by its Constitution) to maximise the milk price. In this matter, Miraka referred to the "milk price", not the "base milk price" as mis-quoted by the Commission. The latter is the technical output of the milk price model. Miraka was referring to the fundamental drivers for Fonterra to take actions that will ensure maximum returns to its co-operative suppliers and the key incentive this represents for Fonterra performance.

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2.6.1 During the televised presentation in September 2014 of its 2013/14 financial results, the interviewer sought clarification concerning the margin squeeze impacting on Fonterra profits. Mr Wilson spoke about the practical realities resulting in the discount of 53 cents that was applied in the 2013/14 final milk price, but stated that "[the] absolute focus of Fonterra was to maximise that payout"[2]. This was a stage-managed presentation. There can be no doubt that Mr Wilson was making an unequivocal statement of the purpose and intent of the Fonterra Board and Executive. On the other hand if the Commission's view on this matter were correct, to explain the reduction in the milk cost Mr Wilson would rather have said "the absolute focus of Fonterra was to maximise profit". But he did not.

2.6.2 Again in an interview given on 2 February 2015, responding to a question (from interviewer Jamie MacKay) concerning a possible reduction in the milk price forecast for the 2014/15 Season, John Wilson reiterated: "We're a co-operative Jamie – *our driver every day is to maximise the milk price to our farmers*"[3].

<u>Providing for Contestability in the market for the purchase of milk</u>

2.7 Miraka has previously submitted that the basis for setting the Notional Producer costs are understated and the milk price is overstated. This inhibits rather than provides for contestability in the market for purchases of raw milk. More fundamentally, the contestability requirements of the Act are undermined by the Commission's interpretation of the test of practical feasibility. Assumptions, inputs and processes are considered to be "practically feasible" (and therefore compliant with the Act) if Fonterra (or another efficient processor) could feasibly achieve them[4]. This sets the bar on practical feasibility very high, as it sets costs and other assumptions based on scale opportunities which existing processors or prospective entrants cannot feasibly enjoy (noting that Fonterra processes over 85% of the milk in New Zealand).

<u>Impact on Dairy Processor Profitability/Assessment of Aggregate Profitability</u>

2.8 Fonterra's final milk price for the 2013/14 Season included a discount of $0.53/kg MS on the milk price calculated using the Fonterra Milk Price Manual. In explaining this discount, the Chairman of Fonterra John Wilson said "we had to face the reality that we had a milk price … based on a theoretical construct. And we had to build a bridge between that theoretical construct and the reality of the … historical assets that Fonterra has on the ground"[5]. This is a blunt but useful description of the commercial

[2] At 5'at'32": http://www.fonterra.com/nz/en/Hub+Sites/News+and+Media/Annual+Results+2014+Videos

[3] At 4'45": http://www.farmingshow.com/on-demand/audio/john-wilson-chairman-of-fonterra-32/

[4] In its "Final Report on the Review of Fonterra's 2014/15 Milk Price Manual (15 December 2014) the Commission mis-stated the Miraka position on this matter. To be clear, Miraka understands that the "efficient processor" does not only mean Fonterra. The point Miraka is making is that by including Fonterra in the efficient processor test, by definition that locks in the cost advantages of scale into the Notional Producers costs, when in reality those scale advantages are not available to any feasible other "efficient processor".

[5] At 5'at'45": http://www.fonterra.com/nz/en/Hub+Sites/News+and+Media/Annual+Results+2014+Videos

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problem created by the theoretical milk price calculation. Despite the discount of $0.53/kg MS, Fonterra profit after tax was still just $179M (prior year $736M) and Fonterra was only able to pay a full year dividend of $0.10 (compared to $0.32 in the previous two years). Because the final milk price was still not based on Fonterra actual performance, it remains unclear the extent to which the final milk price still included a subsidy compared with the actual performance of Fonterra's commodity ingredients.

2.9 The recent publication of Fonterra's interim results for FY 2015 (including half year results for to January 2015) indicates Fonterra profitability has not recovered. Despite a reduction in the forecast milk price to $4.70 (presumably based on the Milk Price Manual), Fonterra profit after tax for the first six months was $183M (prior year $217M). Of more significance, Fonterra has actually reduced its full year dividend estimate by $0.05/kg MS (from a range of $0.25 to $0.35, to a range of $0.20 to $0.30). At the very simplest level, from a decline in milk cost of $3.70 (from $8.40 last year to $4.70 this year) Fonterra has only been able to extract an improvement in dividend of $0.15 c/kg MS (based on the mid-point of current range). The decline in the forecast dividend was extraordinary and was unexpected by financial markets. On the day Fonterra issued its Interim Results, units in the Fonterra Shareholders Fund dropped from $5.99 to $5.56. Units dropped further to an all-time low of $5.10 on 16 April but have since somewhat recovered to $5.40 as at 24 April 2015[6].

2.10 Fonterra has provided some explanation for the deterioration in first half FY 2015 profits and in the forecast dividend. Considerable attention is placed on the high value of opening inventories which Fonterra suggests caused a "margin squeeze" on sales in the first quarter of 2014/15. By the time Fonterra finalises inventory valuation most if not all inventories have already been contracted for sale, and inventory values should have been written down to market value as necessary. A more likely explanation for the decline in profits was therefore not a margin squeeze as such, but a <u>difference</u> in first quarter margins between FY 14 and FY 15. Fonterra also alludes to this in its explanation. Margins in Qtr 1 FY 14 were high because the cost of opening inventories was low, while margins in Qtr 1 FY 15 were low because opening inventory, rather than being high, was already valued at market price and so generated low or no margin. This is an aberration of the Fonterra inventory valuation process, where cost is determined by average selling prices through the season. The accounting effect is to distort intra-period performance. It can be concluded that the underlying economic performance of Fonterra was in fact (even) worse than presented in the FY 2014 Financial Accounts. This suggests the gap between the real performance of Fonterra commodity ingredients in the 2013/14 Season and the Notional Producer was significantly worse than the $0.53 discount provided. The failure in recovery of profitability in FY 2015 despite the massive decline in the milk cost also suggests the underlying subsidy in the Base Milk Price calculations remains a significant drag on Fonterra profit performance.

[6] The latter two prices quoted for 16 April and for 24 April are ex-dividend of $0.10.

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2.11 Because of its position in the New Zealand market, the Fonterra milk price largely sets the milk price for the entire industry. To the extent that the subsidy implied in the base milk price calculation is undermining Fonterra financial performance, it is also undermining the financial performance of other dairy processors. With this in mind, Miraka strongly supports the steps the Commission is now taking to assess aggregate practical feasibility of milk price assumptions and calculations, including a comparison of performance between NZMP and the Notional Producer, and a review of investment markets assessment of NZMP performance.

2.12 To assist in its assessment of aggregate practical feasibility of the Notional Producer the Commission has requested that independent processors provide cash cost information of their own activities. Miraka is willing to assist the Commission where this is within a meaningful analytical framework. While the Commission continues to include Fonterra itself as a benchmark for the test of practical feasibility, Miraka believes there is limited value in comparing its costs with the Notional Producer. Miraka is willing to discuss this further where for example the Commission believes there is merit in reviewing specific cost items which might be unaffected by a comparison with Fonterra's scale. Miraka is also willing to provide yield data to assist in assessing practical feasibility of the Notional Producer yields. Miraka cannot provide that data within the framework of the processes and assumptions used in the milk price model[7]. The Commission is requested to contact the undersigned to discuss how Miraka yield and cost data could best be provided and utilised.

3.0 **<u>Other Issues:</u>**

<u>Selling Prices</u>

3.1 At paragraph 21, the Commission notes it "will look at whether the GDT pricing used in the milk price is consistent with the modelled notional volumes" of the Notional Producer. It is unclear what the Commission means here by "consistency". Miraka and other submitters have pointed out that the Notional Producer could not in fact sell the modelled notional volumes at the GDT prices. This is because the Notional Producer volumes imply an increase in global availability which would depress global prices. This is for example illustrated by the real world reaction to recent indications of an emerging NZ drought (causing prices to rise in February/March followed by a rapid price correction when it was determined the drought would not severely reduce availability - see table 1 below). The signalled volume changes were relatively small compared to volume changes that would result if the Notional Producer were not fictional. But the effect on prices was substantial.

3.2 The conundrum of the feasibility of the Notional Producer revenue would be resolved if the Notional Producer scale (and costs) were consistent with the real world market from which the Notional Producer prices are derived. In any other sense, there seems little

[7] As described in Section 1.2 of "Background of the categories of the base milk price calculation (7 April 2015)" – a document attached to the Process and Issues Paper.

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that could gained from assessing the "consistency" of GDT prices with the Notional Producer *modelled volumes.*

Table 1: Fonterra RWMP Price Response to Drought Expectations

		Fonterra Regular WMP Contract 2 (1)		
		Price	Price Change	
Auction Event	Auction Date	US$/MT	US$/MT	%
129	2 Dec 2014	2,110		
130	16 Dec 2014	2,210	100	5%
131	6 Jan 2015	2,245	35	2%
132	20 Jan 2015	2,330	85	4%
133	3 Feb 2015	2,840	510	22%
134	17 Feb 2015	3,210	370	13%
135	3 Mar 2015	3,195	-15	0%
136	17 Mar 2015	2,840	-355	-11%
137	1 Apr 2015	2,450	-390	-14%
138	15 Apr 2015	2380	-70	-3%

(1) Source: http://www.globaldairytrade.info/en/product-results/

3.2 By contrast, and as previously raised by Miraka with the Commission, there should be some concern about the lottery aspects to the mechanism by which GDT prices are applied to the sales of the Notional Producer. Prices that emerge from GDT are at least partially dependent on the availability of product on GDT (as reflected in Fonterra's forecast signals, actual monthly availability, and contract date profile). This dependence on availability is again illustrated in the above brief series of recent WMP prices. The GDT prices are then applied to the different monthly availability and contract date profile of the Notional Producer. The resultant average prices for the Notional Producer are neither the same as GDT average prices, nor the same as the actual prices Fonterra achieves for its sales. This "hybrid" price is in effect a lottery depending on random differences between the Notional Producer's phasing and contract profile and that of GDT. The Commission has previously assessed the extent to which this "lottery" of prices might distort the revenue of the Notional Producer. Miraka recommends that the Commissions include this review as a regular part of its annual process.

Milk Collection Costs

3.3 In the attachment to the Process and Issues Review Paper, the Commission provided a "Background of the Categories of the Base Milk Price Calculation". This included assumptions that Fonterra had provided as part of its "Reasons" paper for the 2013/14 Milk Price Calculations. Item 4.1 includes an assumption "That the NMPB assumes sufficient processing capacity in both the North Island and South Island, and would therefore not have had to transport milk between island in 2013/14". The Commission is requested to consider why this was recorded as an assumption. It is presumed that the Notional Producer production facilities are "fixed" as to size and location at the time at which those facilities are assumed to be provided. The requirement to move milk

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between Islands is therefore based on a parameter driven assessment (daily milk, location of milk, location of available facilities). There should be no “assumption” as to whether milk is or is not moved between the Islands. The Commission is requested to ensure a proper assessment of this item is made for the 2014/15 Season.

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